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In Pursuit of Value

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SL Advisors, LLC is a registered investment advisor offering separately managed accounts to individuals, family offices and institutions.

Quarterly Outlook

Investing for the long term was not particularly fun over the last three months. Losing 14.5% (the drop in the S&P500 since June) compares unfavorably with certain invasive medical procedures and unsolicited mail from the IRS. It therefore seems entirely appropriate to try and inject some lightheartedness into a period that is seriously not funny via Kal's timeless cartoon below (published with kind permission from Kevin KAL Kallaugher, The Economist, Kaltoons.com). On my office wall hangs a copy signed by Kal himself. I acquired it from the artist back in 1997, although I recall first seeing it in 1989 when stocks collapsed following the failed LBO of United Airlines (who now remembers that?). Since memories of the 1987 crash were still so fresh, the response of equities at the time was violent. Every few years market conditions render Kal's creation a valid commentary.

The equity risk premium (as defined as the earnings yield on stocks minus the yield on the ten year treasury note) is wide for good reason. 2012 consensus earnings for the S&P 500 of $105, which implies an earnings yield of 9.3% (September 30 S&P 500 at 1131) and a spread over the 1.90% yield on the ten year treasury of 7.4% is wide by any measure. It last reached these levels in 1973, during the Yom Kippur War and the OPEC oil embargo. Today's problems are different and maybe far worse. An assessment probably depends as much on whether one's philosophy of life is optimistic as on how the macro issues will play out. For our part, we are cautiously constructive and maintain equity exposures at neutral, believing that current valuations offer a sufficient discount for the risks.

While respectable cases both for and against equities can be made, the absence of value in bonds seems far less contentious. No doubt for most of those holding this view (like us), they held it at higher yields than these and so far it has not been right. At the risk of being stubborn, lower bond yields simply make it more right than it was. The latest Federal Reserve plan to shift its purchases of bonds to longer maturities ("Twist") has perversely caused short term rates to drift up somewhat even while the Fed's prospective buying (and coincident negative economic outlook) has driven long term yields down. In fact government bond markets are increasingly manipulated by governments, and therefore look less appealing places to invest. Even without a view on whether inflation in five years will be sharply higher, lending to anybody for ten years at less than 2% doesn't seem much more compelling than holding cash. For the taxable investor assuming a 40% tax rate, 2% pre-tax is 1.2% after tax which over ten years turns $100 into just under $113 (and unless inflation averages no more than 1.2% over the same period guarantees a loss in purchasing power). The economic environment that would make today's buyer of 2% yielding government bonds happy in ten years' time is unlikely to be kind to most types of credit risk. High grade corporate bonds linked as they are to government bonds offer only modestly better prospects. So today's buyer of corporate bonds desires many years of economic misery to contain inflation but not so much so as to damage corporate creditworthiness, a fairly precise forecast that doesn't leave much room for error in either direction.

Virtually all investors have an allocation to fixed income in one form or another. While bonds have not looked cheap for a long time it does seem that today's low yields, distorted as they are by government intervention, demand a robust response from investors. Since public policy is to make the goal impossibly narrow, maybe it's time to take your ball and go home. If an investor shifted $100 out of fixed income and allocated $80 to 0% yielding cash, the remaining $20 invested in risky assets (such as equities) need only grow at 6% p.a. pre-tax to generate the same $113 of ultimate value as in the ten year treasury example above (assuming a 15% tax rate on dividends and capital gains).

To illustrate with some brief Math: since dividend yields are 2%, this only requires 4% of annual growth. 2% dividend yields imply companies are paying out only 2/9ths of profits (as earnings yields are 9%). The remaining 7/9ths that's retained would need to earn a return on equity (ROE) of only 5% to generate the 4% dividend growth noted above (dividend growth = % of earnings retained X ROE; 7/9ths of 5% is approximately 4%). A 5% ROE is around half the current cost of equity implied by the S&P500's 9% earnings yield. To summarize without the Math – being more pessimistic than this probably isn't the winning side of the trade over the long run. In the short run, anything can happen.

The 80/20 Cash/Stock substitute for fixed income doesn't need to jump very high to clear the performance hurdle that's been set. It incorporates some attractive upside, in that dividends may grow faster than 4%. And one day in the far distant future, maybe cash will even sport a yield again as it once did. This strategy also provides the flexibility to invest some of the cash at a later date, perhaps when the economic outlook is clearer and when bonds would presumably have to be sold at a loss.

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

We don't yet have the requisite Newsweek cover announcing "Why You Should Only Invest in Bonds", but the Math is starting to look compelling. Alternatives to bonds include MLPs (currently offering around 6% tax deferred yields with a solid history of distribution growth); stocks with long histories of reliable dividends; bank debt, and the cash/equities barbell described above.

Hedged Dividend Capture Strategy

Regular readers of this newsletter will be familiar with our antipathy towards U.S. interest rate policy. A stealth transfer of real wealth from the thrifty to the profligate has been under way since 2008 with no sign of ending anytime soon. As the Federal Reserve buys more bonds, our thinking is that investors should hold less. The Math is particularly unappealing as discussed above.

To that end, SL Advisors is launching **The Hedged Dividend Capture Strategy** which seeks to generate income from a portfolio of dividend paying stocks hedged with a short position in the S&P500. By selecting a diversified portfolio of stable companies with a history of earnings growth and reliable dividends, the strategy exploits the fact that many companies sport dividend yields that are comparable with bond yields (and dividends grow, whereas bond coupons don't). Such stocks generally move less than the market, and so it's possible to hedge them to be "beta" neutral and so reduce the day-to-day risk while still maintaining an overall long position. The net result is a portfolio that has similar volatility to corporate bonds but we believe has a much more attractive return potential through earnings growth.

As pointed out in the article above, replacing some fixed income exposure with a combination of as little as 20% in equities and the rest in cash provides a more attractive risk/return profile than is currently available in bonds. **The Hedged Dividend Capture Strategy** offers a similar opportunity to seek better overall returns using a diverse portfolio of regularly profitable companies while maintaining levels of risk commensurate with high grade corporate bonds.

We would be happy to discuss the strategy in more detail with anyone interested in an alternative to today's ruinously low interest rates which virtually guarantee a loss in purchasing power after taxes and inflation.